CUMBERLAND
Private Wealth

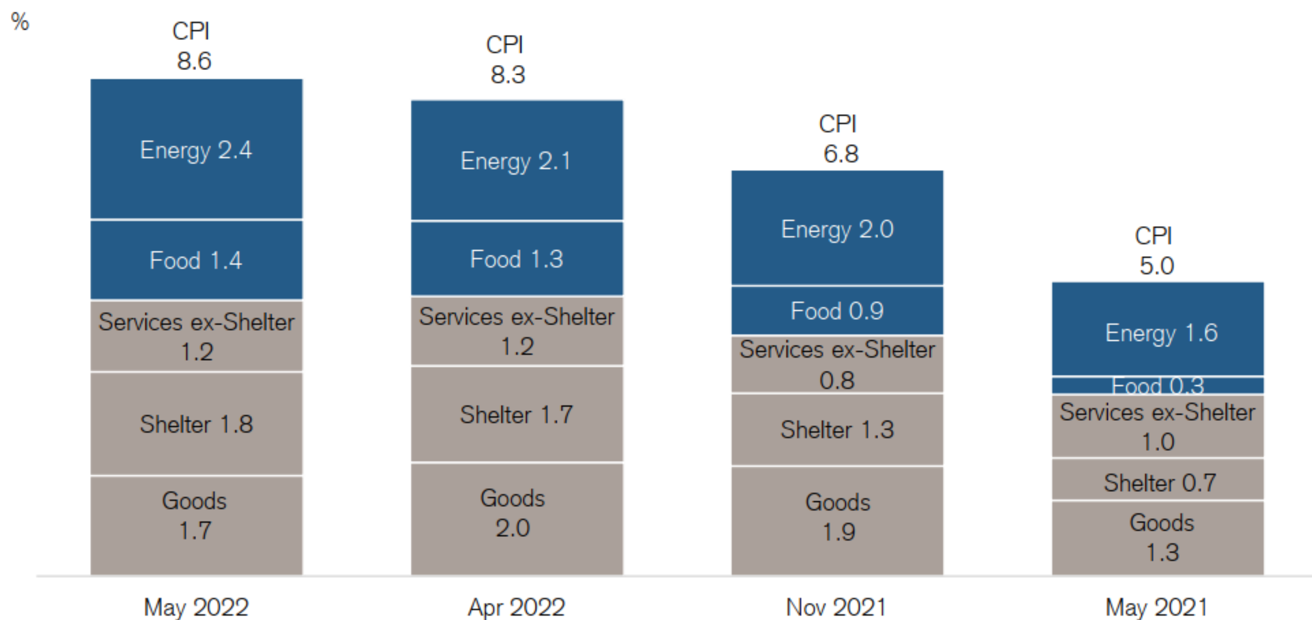
June 30, 2022

Second Quarter Review

NORTH AMERICAN EQUITY STRATEGY

The S&P500 officially entered a bear market on June 13th after it fell -21.8% from its January 3rd high. Any decline over -20% is considered bear market territory. For the second quarter ending June 30th, the S&P500 total return was -16.1% in US dollars. Adjusting for currency, the S&P500 returned -13.5% in Canadian dollars, as the Canadian dollar depreciated about 2.3 cents, closing the quarter at US$0.7768. The TSX total return was -13.2% in the second quarter. Greater detail can be found in **Appendix 2**. The main cause of the decline was probably the May CPI inflation data (**Exhibit 1**) pressuring the Federal Reserve (Fed) to increase the federal funds rate by 75 basis points in June shortly after the inflation report.

Exhibit 1:
CPI Year over Year Breakdown



Source: Credit Suisse, Golub et al, U.S. Equity Strategy, 06/20/2022

Initially, the Fed believed inflation was transitory blaming used car prices, supply chain disruptions, Chinese shutdowns and geopolitical conflicts impacting food and energy prices. However, it turns out that inflation is far more pervasive and in the Federal Open Market Committee's (FOMC) June 15th press release, it became abundantly clear that the Fed's primary goal had shifted away from controlling inflation while maintaining a strong labour market to just fighting inflation at any cost (**Exhibit 2**).

Exhibit 2:
Federal Reserve issues FOMC statement (June 15, 2022)

The Committee seeks to achieve maximum employment and inflation at the rate of 2 percent over the longer run. ~~With appropriate firming in the stance of monetary policy. The committee expects inflation to return to its 2 percent objective and the labout market to remain strong~~. In support of these goals, the Committee decided to raise the target range for the federal funds rate to ~~3/4~~ 1-1/2 to 1-3/4 percent and anticipates that ongoing increases in the target range will be appropriate. In addition, the Committee ~~decided to begin~~ will continue reducing its holdings of Treasury securities and agency debt and agency mortgage-backed securities, as described in the Plans for Reducing the Size of the Federal Reserve's Balance Sheet that were issued in ~~conjunction with this statement~~ May. The Committee is strongly committed to returning inflation to its 2 percent objective.

Source: Federal Reserve, FOMC Press Release 06/15/2022

Chair Powell went on to say that another 50-75 basis points rate hike would also be appropriate at its July meeting. The implication is the potential for a more severe blow to the labour market and slower economic growth. As indicated in **Exhibit 3**, which shows FOMC projections over the next three years compared to where they were in March, the FOMC downgraded its GDP projections and boosted its forecast for unemployment over the next three years while increasing its inflation outlook for 2022 but maintaining or lowering its longer-term inflation expectations. They still expect inflation to return to a low 2% range by 2024 and beyond. This was accomplished by materially increasing the Fed's forward guidance for the federal funds rate to 3.4%, 3.8% and 3.4% through 2022, 2023 and 2024, respectively.

Exhibit 3:
Federal Reserve: Summary of Economic Projections

Percent

Variable	Median[1]			
	2022	2023	2024	Longer run
Change in real GDP	1.7	1.7	1.9	1.8
March projection	2.8	2.2	2.0	1.8
Unemployment rate	3.7	3.9	4.1	4.0
March projection	3.5	3.5	3.6	4.0
PCE inflation	5.2	2.6	2.2	2.0
March projection	4.3	2.7	2.3	2.0
Core PCE inflation[4]	4.3	2.7	2.3	
March projection	4.1	2.6	2.3	
Memo: Projected appropriate policy path				
Federal funds rate	3.4	3.8	3.4	2.5
March projection	1.9	2.8	2.8	2.4

Source: Federal Reserve, FOMC, Summary of Economic Projections, 06/15/2022

If there is any good news to come out of this, the Fed's forward guidance now appears to have caught up with what the market is expecting for future policy rates, which reduces some of the market uncertainty and likelihood of more big surprises from the Fed. **Exhibit 4** shows the Fed's projections (dot plot with green line representing median projection) versus the Fed funds rate implied by the market (red line). The problem though is that with the Fed funds rate now only at 1.5% to 1.75% today, we still have a long way to go to get to 3.8% by the end of 2023 and the market's focus has likely now shifted to whether the Fed can engineer a soft landing or not as it moves toward this higher level.

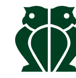


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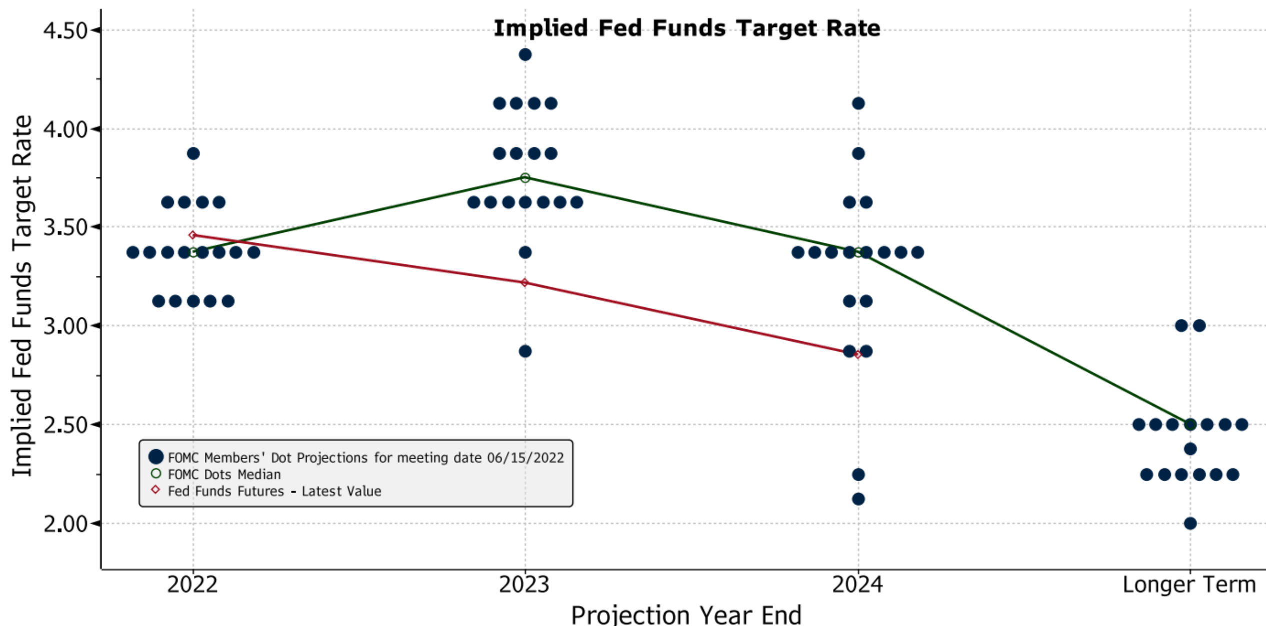
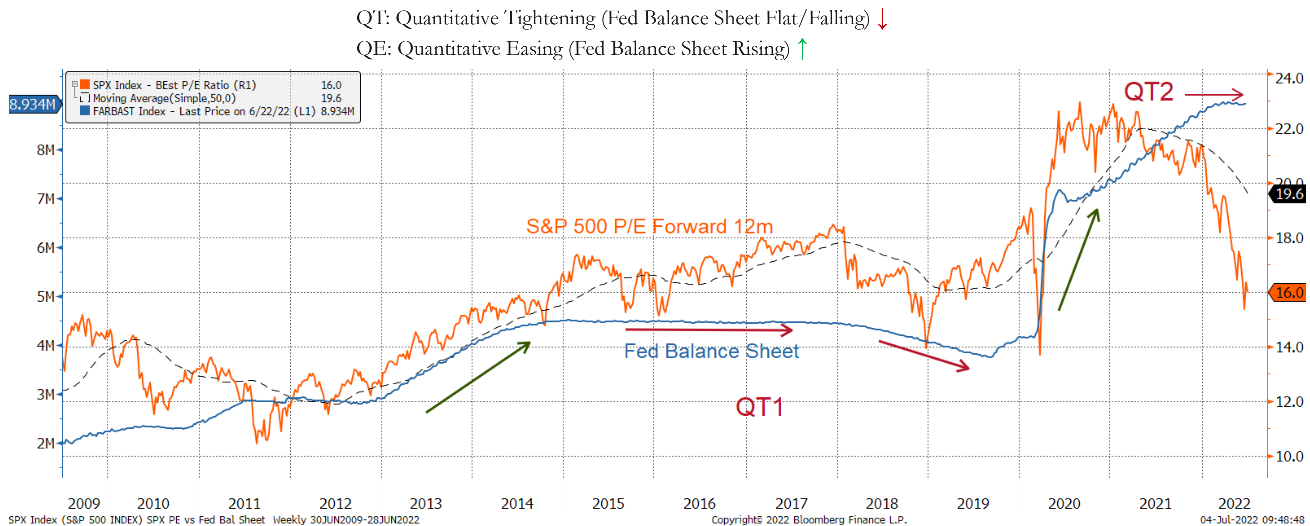
Exhibit 4:
FOMC summary of Economic of Projections vs Market Implied Fed Funds Target Rate



Source: Bloomberg, DOT

The other issue is Quantitative Tightening (QT), which began June 1st. There has not been a lot of great analysis done on this by market participants in our opinion; however we have a few observations. **Exhibit 5** graphically compares S&P500 the 12-month forward price earnings (P/E) multiple (orange line) to periods of Quantitative Easing (QE) and QT (blue line). As indicated in the chart, periods of QE or when the Fed is expanding its balance sheet (green arrows) appear associated with rising forward P/E multiples and the opposite appears true associated with QT (red arrows). While we have already seen a significant contraction in the 12 month forward P/E multiple this year, the question remains whether that was associated with the anticipated move up in the fed funds rate (forward guidance) driving up 10 year treasury yields from about 1.5% at the beginning of January to close to 3% today, or QT, or perhaps a combination of both. The bottom line is that we don't know. That is, it is not clear how much QT is priced into equity valuation multiples so far. Even Chair Powell stated at his May 4th press conference that a $1 trillion reduction in the Federal Reserve's balance sheet (ie: QT) equates to a 25 basis point rate hike but then went on to say "with a very wide uncertainty band - very wide. We don't really know". What we do know is that the magnitude of this QT program (QT2), which began June 1st at $47.5 billion per month, and will increase to $95 billion per month in September, is almost double the October 2017 QT program (QT1), which started at $10 billion per month increasing to $50 billion per month over the course of 12 months and was phased out in March 2019 after some extreme market volatility in late 2018.

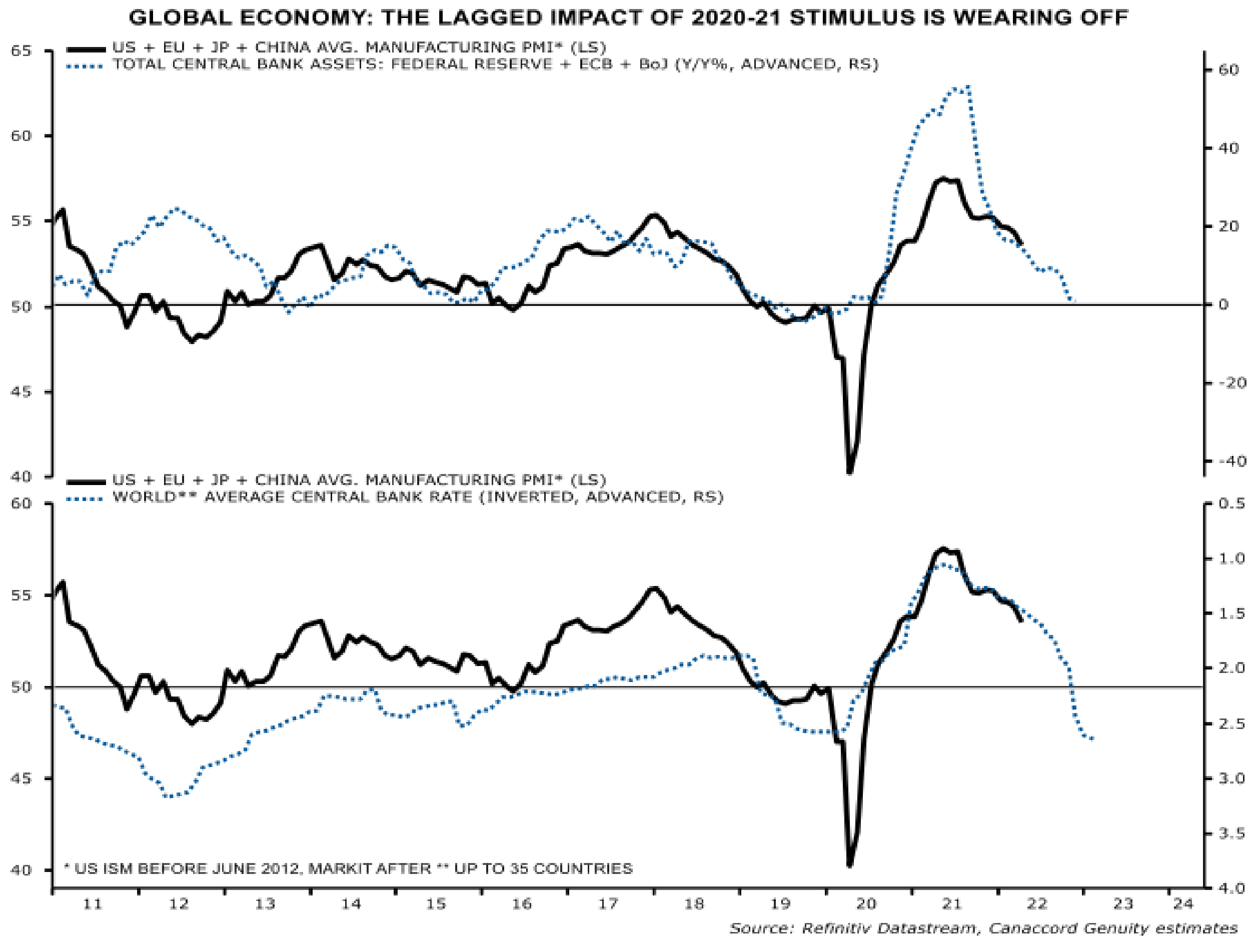
Exhibit 5:
S&P500 12m forward P/E during QE (Fed balance sheet Rising) and QT (Fed balance sheet Flat/Falling)



Source: Bloomberg, SPX Index, FARBAST Index, 06/30/2009-06/30/2022

In **Exhibit 6**, the top clip illustrates the historical impact of expanding and shrinking Central bank balance sheets (Federal Reserve, European Central Bank, Bank of Japan) on global manufacturing PMIs, whereas the bottom clip shows the correlation between global policy rates and world PMIs. In both cases, it suggests global manufacturing activity is likely to stall going into the second half of 2022 with the impact of higher policy interest rates and QT. The extent to which this could lead to a global growth scare and lower earnings remains to be seen and this is our main concern going into the second half of 2022.

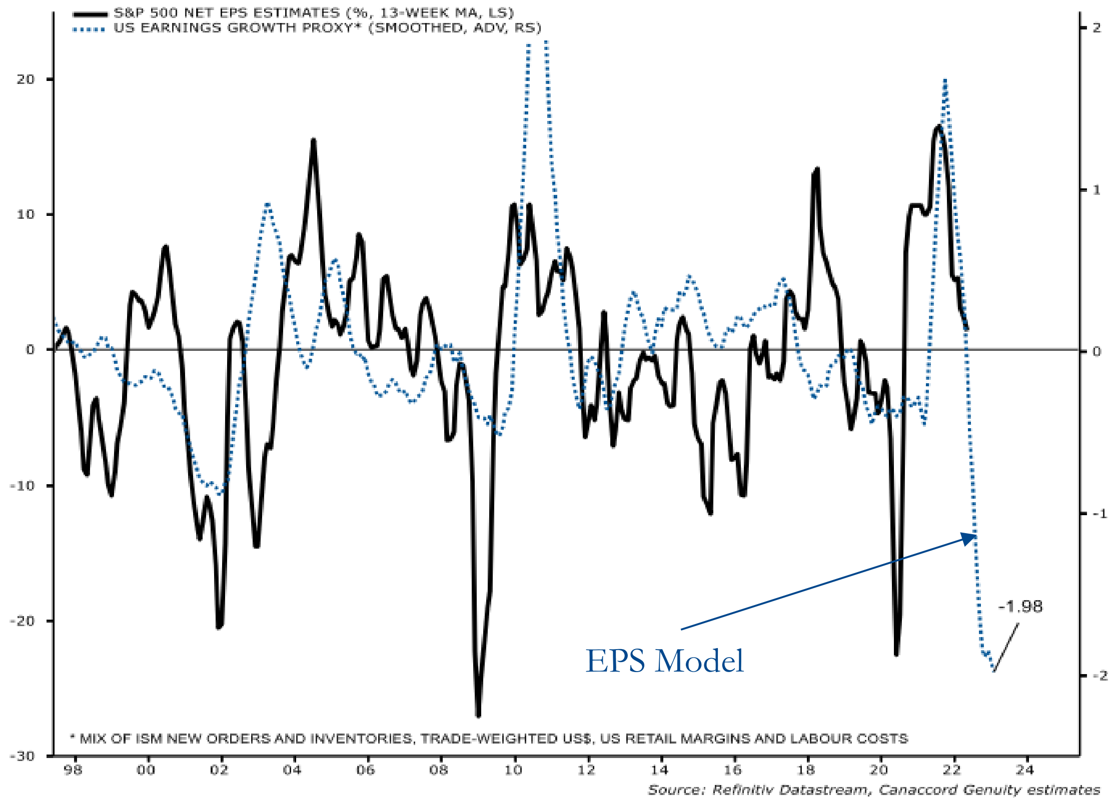
Exhibit 6:
Central Bank Assets and Policy rates versus Global Manufacturing PMI’s



Source: Canaccord Genuity, North American Portfolio Strategy, Roberge et al, June 2022

In **Exhibit 7,** we examine an earnings growth model that compares future S&P500 earnings estimate changes to a number of components that correlate with the direction of future earnings estimates. These include ISM new orders, inventories, trade weighted US$, US retail margins and labour costs. The most concerning point here is that “all” components currently project negative future earnings momentum concurrently causing the exaggerated decline (blue line) in the chart! This has been one of our concerns for some time but somehow Wall Street analysts have not yet factored these slowdowns into their projections.

Exhibit 7:
US Earnings Growth Proxy vs S&P500 Net EPS Estimates



Source: Canaccord Genuity, North American Portfolio Strategy, Roberge et al, June 2022

As one strategist we follow likes to point out, the bottom-up analysts did not get the memo regarding the direction of earnings as illustrated in **Exhibit 8.** Bottom-up consensus earnings estimates have continued to increase so far in 2022. The second quarter reporting period and earnings guidance for the second half however, will be a key indicator of future earnings growth. One notable observation we see is that forward earnings estimates have come down a little in the past couple weeks so time will tell as to how this will play out. For now, we are happy to remain defensive with a bit of extra cash reserves and concentrating on owning companies with lower volatility, consistent earnings and strong and growing dividends.

Exhibit 8:
S&P500 Bottom-up consensus earnings estimates

Source: FactSet, Bloomberg

Asset Allocation for our North American Equity Strategy As at June 30, 2022

Equities	89%
Fixed Income	0%
Cash	11%

During the quarter, our overall equity exposure decreased another 4% to 89% from 93% at March 31st. Our US equity exposure decreased from 43% to 39% while our Canadian exposure was flat at 50%. Cash increased from 7% to 11%. It is important to note that many of our clients' portfolios are invested in our North American plus International Equity strategy, meaning that the actual weights of US and Canada within their equity holdings will be proportionately less than this given the allocation to international companies.

Currently our portfolio is positioned toward value-oriented stocks that typical trade at or below market earnings multiples, while maintaining exposure to growth stocks at around 1/3 of the portfolio. More specifically, our current allocation to growth stocks, which typically rely on trends independent of the economy, has increased to 32% from 29% at March 31st; while that of value stocks, which are more

correlated with the economic, are down to 53% from 60% at March 31st. Staples (4%), which we don't classify as either growth or value, make up the balance of our equity exposure. Most of the shift away from value during the quarter came from our reduction in financial services or more specifically Canadian and US banks. These initially benefit in a rising interest rate environment but struggle heading into recessions as the credit cycle worsens, on loan loss and investment banking concerns. Our shift towards growth reflects our increased exposure to Healthcare, in particular Johnson & Johnson (JNJ), which has demonstrated strong secular growth regardless of the economic landscape. JNJ has a 20 year compound annual growth rate of 6% sales and 8% earnings per share with 60 consecutive years of dividend growth. A complete review of the business and fundamental outlook for new companies purchased during the quarter can be found in **Appendix 1**.

Closing Comments and Outlook

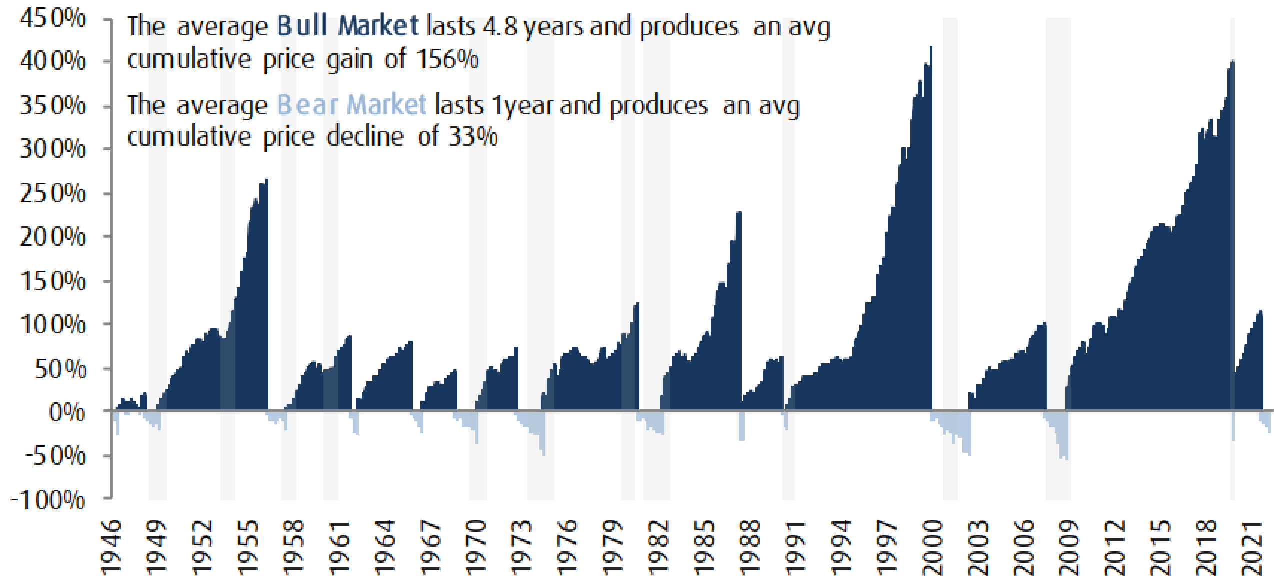
In closing, we attempted to cover some of the issues facing this market including inflation and how the Federal Reserve is dealing with it. Inflation is far more pervasive than the Fed originally believed and in its June 15th press release, it became abundantly clear that its primary goal had become fighting inflation potentially at the expense of the labour market and economy. If there is any good news, it might be that the Fed's forward guidance on interest rates appears to have caught up with the market implied rates but there is still a long way to go to get to the FOMC's target level of 3.8% by the end of 2023 as we are currently only at 1.5-1.75%. The market's focus will now likely shift to whether the Fed can engineer a soft landing or not.

The other issue is Quantitative Tightening (QT2), which began June 1st. Even by the Fed's own admission, they are unsure of the overall market/economic impact of QT. We just know the magnitude (and pace) is about two times that of QT1 in 2017-2019, which did not end well. The extent to which shrinking central bank balance sheets could lead to a global growth scare and lower earnings remains to be seen, however this is our main concern going into the second half of 2022.

Having said that, bottom-up consensus earnings estimates have continued to increase through the first half of 2022 but the second quarter reporting period and earnings guidance for the second half should be a key indicator going forward.

From the January 3rd peak to the current bear market trough reached on June 16th the S&P500 is down -23.6%. As indicated in **Exhibit 9**, the average bear market lasts about 1 year producing a cumulative price decline of -33%. Perhaps more importantly though historical average bull markets last 4.8 years in length or almost 5x the duration of bear markets and produce average cumulative price gains of 156%! What we don't know is whether this is an average bear market or whether the Fed be able to engineer a soft or hard landing. According to BMO Capital Markets, the average historical non-recessionary bear market going back to 1945 returns -27.6%, and if we don't enter a recession, we are pretty much there. However, the average historical recessionary bear market return is -34.8% which implies more financial pain if we do enter a recession.

Exhibit 9:
S&P 500 Bull & Bear Markets: Cumulative Price % Change since 1945; dark blue shading: bull markets; light blue shading: bear markets; gray shading: recessions



Source: BMO Capital Markets, Belski et al, U.S. Strategy Snapshot, 06/23/2022

Given the strength and duration of bull markets, it's really critical to be invested at those times. The trouble is that it's really tough to exactly determine the bottom of a bear market and the start of a new bull market, and the true beginning of a new bull market typically doesn't feel like a very comfortable time to invest when it may just be the best time to do so. There is never an all-clear signal and periods of extreme uncertainty may remain for some time despite a new bull market being well on its way.

For now, we are happy to stay on the sidelines with a bit of extra cash as reserves, concentrating on owning companies with lower volatility, consistent earnings and strong and growing dividends. What we don't want to lose sight of is that paradoxically, risk aversion tends to peak at the bottom of bear markets and is at its lowest at the peak of bull markets, which is precisely the opposite of where risk aversion should be at those times. Some of the signs we will watch for that might cause us to get more constructive may include signs of peaking inflation, higher unemployment and a shift in Fed policy stance. Also, a higher level of capitulation in stocks more in line with the historical averages discussed above would also create a valuation reset and potentially a more compelling entry point.

Peter Jackson
Chief Investment Officer
June 30th, 2022

APPENDIX 1

NEW EQUITY INVESTMENTS:

NORTH AMERICAN EQUITY MANDATE

CANADA

Bank of Montreal

We switched out of TD bank in favour of Bank of Montreal at the end of the first quarter 2022.

Both companies did a recent acquisition in the US with similar EPS accretion metrics; however, the accretion on both deals is 1 year sooner for BMO based on management's guidance. Both companies beat on earnings in Q1; however, BMO had the highest loan growth and TD had the weakest. TD is no longer #1 in credit cards and appears to be losing market share. BMO presented a strong outlook on their first quarter earnings and acquisition call whereas TD did not. Our ROE/Target price to book value model calculates materially more upside for BMO (>2x's) that of the current upside for TD.

Keyera Corp

Keyera is a Canadian midstream energy company providing gas gathering and processing, transportation, storage, fractionation, marketing, and pipeline services to its upstream producer clients. It owns Alberta EnviroFuels whose main output, iso-octane, is blended with traditional fuels to reduce carbon emissions. We think Keyera has an attractive pipeline of projects, including the KAPS pipeline, which will connect their BC gas plant with their Fort Saskatchewan infrastructure. We also like management's efforts to reduce their dependance on commodity prices. Upon completion of the KAPS pipeline, 75% of their EBITDA will be fee-for service and will fully cover the dividend, which currently yields over 6%.

Primaris Real Estate Investment Trust

Primaris REIT is a Canadian enclosed shopping centre REIT with a focus on secondary markets in Canada. Following a difficult 2015-2019 shakeout that saw the closure of anchor tenants Target and Sears Canada and then the 2019-2021 effects of COVID 19, this is a deep value survivor benefitting from mall openings following the removal of pandemic restrictions. It trades at a 45% discount to its IFRS net asset value and sports a 6.4% dividend yield.

CT Real Estate Investment Trust

CT REIT is arguably the lowest risk holding in the Canadian portfolio. With 99.3% occupancy and 96.1% of tenants being investment grade, the company has established a track record of stability and a decent 5.1% AFFO per unit CAGR over the last 5 years. The units have a 5.4% yield with a 78% payout ratio on AFFO. Adding the two together generates low double-digit returns, and CT REIT has delivered an 11.9% annualized return since its inception in 2013 (versus 7.2% for the REIT universe). CT REIT has never missed street expectations in any quarter since going public.

Yet the stock recently bounced off its 52-week low as the market adjusts to higher interest rates. While the company has done an excellent locking in rates on its debt (98% of debt is fixed, their average interest rate is 3.87% and minimal debt is rolling over in the next couple of years), industry cap rates will rise with rising interest rates. We feel the units have adjusted to fully reflect interest rate hikes and have very minimal sensitivity to the potential of a slowing economy. With their defensive attributes and with being paid to wait with the strong dividend yield, they are well positioned for the present environment.

UNITED STATES

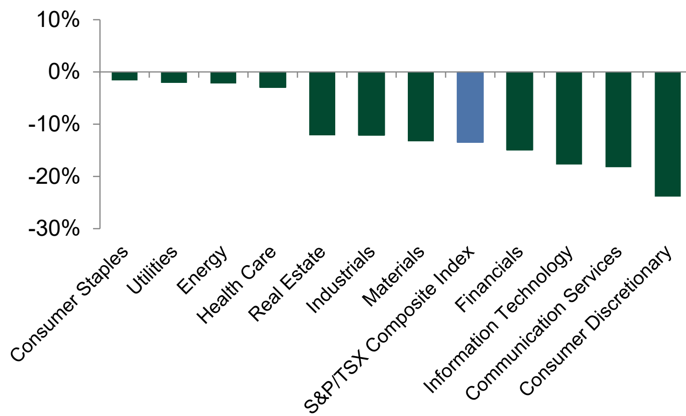
Johnson and Johnson

Johnson & Johnson has leadership positions across a wide number of healthcare segments including Pharmaceuticals, Medical Devices, and Consumer Healthcare. The Pharmaceuticals division focuses on several therapeutic areas including immunology, oncology, neurology, pulmonary, cardiology, and metabolic diseases. The Medical Device segment focuses on orthopedics, surgery tools, and vision care. The Consumer Healthcare segment focuses on baby care, beauty, oral care, over-the-counter drugs, and women's health. The company recently announced its intention to spin out its Consumer Healthcare business into a separate entity in 2023, which will leave the remaining company highly focused on drugs and medical devices. We are excited about the forthcoming spin out because the stock market typically assigns a discount to large conglomerate companies. We believe there is potential for a valuation uplift following the separation of these businesses into two distinct companies. In the meantime, we own a company with a leadership position in a defensive industry that generates substantial free cash flow. Furthermore, Johnson & Johnson is a Dividend Aristocrat that has increased its dividend in each of the past 60 years.

APPENDIX 2

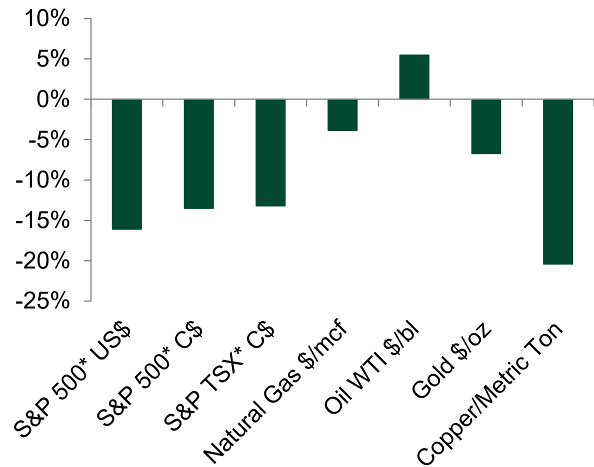
PERFORMANCE CHARTS

S&P TSX (C$ Total Returns)
Quarter Ending June 30, 2022



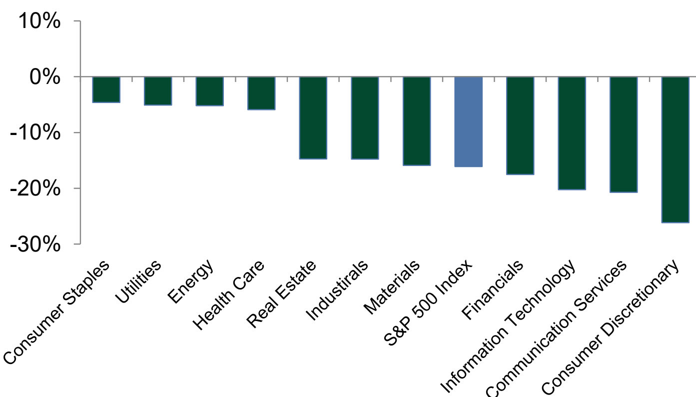
Source: TD Securities

Quarter % Change
Quarter Ending June 30, 2022



Source:Bloomberg *Total Returns

S&P 500 (US$ Total Returns)
Quarter Ending June 30, 2022



Source: TD Securities

*Cumberland and Cumberland Private Wealth refer to Cumberland Private Wealth Management Inc. (CPWM) and Cumberland Investment Counsel Inc. (CIC). CIC acts as sub-advisor to certain CPWM investment mandates.

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